INTERNAL REVENUE SERVICE

IRS News Release

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IRS Reaches Settlement on Aggressive Tax Transaction

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WASHINGTON — The Internal Revenue Service announced today that it has successfully brought to conclusion pending disputes with two unrelated taxpayers, the Diversified Financial Corporation, an affiliate of The Diversified Group Incorporated, and AVM L.P.

Both entities engaged in the brokering of non-economic residual interests ("NERIs") in real estate mortgage investment conduits ("REMICs"). The resolution of these disputes was part of the IRS's ongoing enforcement efforts that are directed not just at listed tax shelter transactions, but at all tax planning strategies determined to be overly aggressive by the IRS.

NERIs are REMIC securities that entitle the holder to little or no cash flow, but typically generate phantom taxable income for the holder in the early years of the REMIC and corresponding amounts of phantom tax losses in the later years. While the phantom losses can be used to offset income from other sources, the holder is prohibited under applicable law from offsetting the phantom income with any type of loss or deduction. As a result, at the time of issuance, NERIs generally have a negative value attributable to the time value of money detriment associated with having to pay tax on the phantom income in the early years of the related REMIC and receiving a corresponding tax benefit from the phantom losses in later years. Because of this negative value, issuers or sponsors of REMICs generally "sell" NERIs by paying the "buyer" an inducement fee.

For some time, the IRS has been concerned that buyers of NERIs have attempted to avoid the tax due during the early years of the related REMIC by taking an overly aggressive interpretation of the applicable tax rules. Diversified Financial Corporation and AVM L.P., a broker-dealer, each purchased NERIs from various Wall Street investment banks and resold them to a Wyoming limited liability company owned by two Irish companies not subject to U.S. tax.

The resolution of the disputed transactions requires each of AVM and DGI to disgorge its profits to the IRS and also imposes penalties and interest. Additionally, the resolution enables the IRS to pursue other participants in the same or related transactions. Moreover, the resolution also preemptively shuts down the deduction of over $1 billion in phantom tax losses arising from the NERIs.

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The total payment to be received by the IRS from the two companies is in the eight figures. The companies have further agreed to cease and desist from engaging in future NERI trading activities and to a limited waiver of the taxpayer privacy and anti-disclosure rules.

Commissioner Mark Everson hailed the resolution of the disputes as yet another example of a tough but measured approach the IRS is taking on not just listed tax shelter transactions but also aggressive transactions in general. "We insisted that the taxpayers not only disgorge all their profits and pay them as additional taxes due but that they also pay a 20 percent penalty."

The agreement reflects the IRS’s commitment to resolving complex contested issues while keeping sight of the ultimate goal — enforcement.

“Due to the dedicated efforts of LMSB examination and counsel personnel, we have demonstrated, without litigation, that taxpayers must be prepared to pay the price for aggressively interpreting the law even if it is unrelated to a listed tax shelter transaction,” said IRS Chief Counsel Don Korb.

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